

United States
COURT OF APPEALS
for the Ninth Circuit

E. J. MURRAY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S BRIEF

*Petition to Review a Decision of the Tax Court
of the United States*

FILED

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JURISDICTIONAL STATEMENT

The jurisdiction of the Tax Court of the United States to entertain the petition herein is based upon Section 272 of the Internal Revenue Code of 1939, as amended (now Section 6213 of the Internal Revenue Code of 1954). This court's jurisdiction to review the Tax Court's decision is founded upon Section 1141(a) of the Internal Revenue Code of 1939, as amended (now Section 7482 of the Internal Revenue Code of 1954).

Petitioner is a resident of Oregon and filed his federal tax return for the calendar year 1947 with the Collector of Internal Revenue at Portland (R. 80).

The opinion of the Tax Court (Arundell, J.) is reported at 21 T.C. (No. 6) p. 1049 and is contained in the Transcript of Record (R. 51-77).

STATEMENT OF THE CASE

This case involved petitioner's income tax for the calendar years 1946 and 1947 for which deficiencies were determined by the respondent in the respective amounts of \$1,967.95 and \$36,656.04. After petitioner had filed his petition with the Tax Court, the tax for the year 1946 was settled by stipulation.

With respect to the year 1947, the Tax Court held adversely to the petitioner by sustaining the Commissioner's determination that petitioner had realized ordinary income in the amount of \$57,512.64 in that year as the result of a final accounting which followed a decision by the Oregon Supreme Court in 1942 determining petitioner's interest in a building known as the "Murray Building," Klamath Falls, Oregon (R. 64).

The Tax Court found in petitioner's favor on several collateral questions involving deductions in 1947 for taxes, interest, depreciation and attorney's fees (R. 65, 74-77), so that the redetermined deficiency for the year 1947 was found to be \$32,332.37 (R. 79).

Petitioner asks for review by this court of the Tax Court's decision only in so far as it determined a de-

ficiency in petitioner's tax for the calendar year 1947 in the amount of \$32,332.37 (R. 80). The correctness of this determination depends upon two alternative propositions: (1) whether petitioner realized any taxable income by reason of the *Murray v. Wiley* litigation; or (2) even if taxable income did accrue to petitioner therefrom, whether it was all taxable to petitioner in the year 1947.

The case was tried upon a comprehensive stipulation of facts (R. 31-51) adopted by the Tax Court (R. 53-64) and summarized below for the convenience of the court.

STIPULATED FACTS

With respect to the questions for decision by this Court, the parties stipulated:

1. In the year 1928, petitioner and his wife, Rebecca J. Murray, purchased as tenants by the entirety certain unimproved real estate situated in Klamath Falls, Oregon. Thereafter, to partially finance the construction of a building on said real property (the property and its improvements being hereinafter referred to as the "Murray Building"), petitioner and his wife borrowed moneys from Pacific Savings and Loan Association, Tacoma, Washington. On August 20, 1932, the property was subject to a first mortgage in favor of the Pacific Savings and Loan Association in the principal amount of \$64,000.00, on which there was a balance due of approximately \$57,000.00 (R. 32).

2. On August 20, 1932, petitioner and his said wife, being then the owners of the Murray Building, conveyed the Murray Building to the Conger Corporation, an Oregon corporation, by deed warranting against all encumbrances except "existing mortgage, liens and taxes." The Conger Corporation was organized on August 5, 1932, the sole stockholders being W. A. Wiley, G. Q. D'Albini and Marie D'Albini, wife of G. Q. D'Albini. Wiley and D'Albini were petitioner's attorneys and petitioner was indebted to them for professional services theretofore rendered. The transaction was handled in the following manner: Wiley and D'Albini borrowed \$5,000.00 from a bank and deposited it to the credit of the Conger Corporation in purported payment for its stock. The Conger Corporation then issued its check for \$5,000.00 to petitioner as purported consideration for the deed of the property to the corporation, whereupon petitioner returned the money to the lending bank in liquidation of the bank's loan to Wiley and D'Albini, whose notes were returned to them. Petitioner also paid a \$10.00 charge for the use of the money (R. 33).

3. In May of 1934, the Pacific Savings and Loan Association brought suit to foreclose its first mortgage on the Murray Building and on March 23, 1935, the property was sold pursuant to a decree of foreclosure for the unpaid balance of \$56,984.78, the mortgagee being the purchaser. On March 21, 1936, the Conger Corporation, which appeared as the record owner of the Murray Building, gave notice of intention to redeem the property. On March 23, 1936, which was the last day of the statutory redemption period, the Conger

Corporation assigned the right of redemption and delivered a bargain and sale deed to the Murray Building to Mary L. Moore, Merle S. West, Charles J. Martin and Thomas B. Watters, hereinafter referred to as the "Watters Group." The same day the Watters Group exercised their purported right of redemption by redeeming the property. They paid to the Sheriff of Klamath County the sum of \$63,711.60, entered into possession thereof, and thereafter claimed to be the owners in fee of the property, free from any claim of the petitioner (R. 33-34).

4. At the time of the conveyance of the Murray Building to the Watters Group, the property was subject to liens for federal income taxes assessed against petitioner and Rebecca J. Murray. In November of 1936, the Watters Group informed the Deputy Collector in charge of collection of such taxes that the Collector should go ahead and sell the property and that the Watters Group would buy it at such sale, thereby better perfecting their title. In April, 1937, the United States Collector of Internal Revenue, Portland, Oregon, proceeded to sell the Murray Building to collect such tax, and it was bid in by the Watters Group for \$16,500.00. The tax liens so satisfied amounted to \$3,148.60 and the expenses of sale were \$4.35 (R. 34-35).

5. On March 22, 1938, petitioner and his wife, Rebecca J. Murray, filed suit in the Circuit Court of Oregon for the County of Klamath entitled "E. J. Murray and Rebecca J. Murray, Plaintiffs, v. W. E. Wiley, G. Q. D'Albini, Marie N. D'Albini, Mary L. Moore, Merle

S. West, Emma West, Charles J. Martin, Lynna Martin, Thomas B. Watters, Evelyn Watters, and J. W. Maloney as Collector of Internal Revenue for the United States of America, Defendants," wherein it was prayed that the court (a) decree that the plaintiffs were the beneficial owners of all right, title and interest in and to the Murray Building, (b) decree that the defendants, other than J. W. Maloney, were trustees holding the premises for the sole and exclusive benefit of the plaintiffs, (c) direct the defendants as trustees to convey the property to plaintiffs, and (d) require the defendants to render an accounting with respect to the operation by them of the Murray Building. On motion of defendant J. W. Maloney the cause was dismissed as to him for lack of jurisdiction. Rebecca J. Murray died on August 8, 1938, prior to any hearing, and petitioner thereafter succeeded to her right, title and interest in the Murray Building as surviving tenant by the entirety. On December 18, 1940, the Circuit Court of Oregon for the County of Klamath, by written opinion, held for defendants, whereupon petitioner took an appeal to the Supreme Court of Oregon (R. 35-36).

6. On June 30, 1942, the Supreme Court of Oregon in *Murray v. Wiley, et al.*, 169 Or. 381, 127 P. (2d) 112, reversed the lower court and held:

(a) That petitioner's conveyance of the Murray Building to the Conger Corporation was made to secure his indebtedness to his attorneys, Wiley and D'Albini, and that the Conger Corporation was the alter ego of Wiley and D'Albini, who were in the position of second mortgagees.

(b) The Conger Corporation held the property as a mortgagee in possession and its purported assignment of the statutory right of redemption affected property belonging to the petitioner and not to Wiley and D'Albini.

(c) The Watters Group, which received a conveyance from the Conger Corporation together with an assignment of the right of redemption, were the assignees of rights which in equity belonged to the petitioner and upon exercising the statutory right of redemption became mortgagees in possession, having the right to foreclose against petitioner, but being subject to his right to redeem upon payment of the sums found to be due them.

(d) The Watters Group had information as to the petitioner's rights in the property, or at least information sufficient to put them upon reasonable inquiry as to petitioner's rights in the property, and were not bona fide purchasers for value without notice.

(e) The petitioner was the beneficial owner of the property subject to the liens of the various defendants who were mortgagees in possession.

(f) The case must be remanded to the Circuit Court for an accounting appropriate to the situation. In such accounting the defendants would be entitled to

(1) Credit of \$63,711.60 paid in redeeming the property, plus interest at 6 per cent per annum from the date of payment.

(2) Credit of the amount of the federal tax lien against the property with interest at 6 per cent per

annum, and to receive from the Collector the balance of funds in his hands over the amount needed to satisfy such lien.

(3) Reasonable fees for the legal services performed by Wiley and D'Albini prior to and owing on August 20, 1932, less offsets for certain cash realized by Wiley and D'Albini on their sale to the Watters Group. Defendants Wiley and D'Albini are entitled to a lien subsequent to that of the Watters Group for any excess of the attorneys' fees remaining unpaid after crediting such cash offsets.

(4) Upon full accounting being had, covering the matters indicated and all dealings by the Watters Group as mortgagees in possession, a decree should be entered fixing the amount, if any, in which the Murray Building is subject to a lien in favor of the Watters Group and also fixing the amount, if any, in which the Murray Building is subject to a subsequent lien in favor of Wiley and D'Albini for attorneys' fees.

(5) The decree should provide that upon payment to the Watters Group and Wiley and D'Albini of the amounts of their respective liens, the defendants be directed to reconvey the property to petitioner, and in default of such reconveyance the decree stand in lieu thereof.

(6) The decree should also provide that if the respective sums are not paid the petitioner be foreclosed by sale, subject to redemption as in other mortgage foreclosures, the proceeds to be applied

first to the usual costs, thereafter to the extinguishment of the lien of the Watters Group, and thereafter to the extinguishment of the judgment and lien of Wiley and D'Albini, if any (R. 36-38).

7. Thereafter, the defendants petitioned the Supreme Court of Oregon for rehearing and on September 29, 1942, that court denied the petition by written opinion in *Murray v. Wiley, et al.*, 169 Or. 418, 129 P. (2d) 66, in which the court held:

(a) That matters relating to defendants' credits for cost of management and repairs to the Murray Building should be determined by subsequent accounting and not on the record then before the court.

(b) That the proceeding before the court was a suit by a mortgagor to redeem and not by a mortgagee to foreclose, and therefore the previous opinion, in so far as it related to foreclosure of petitioner by sale, subject to redemption, would be modified to provide that unless petitioner did redeem the property from the liens the decree of the Circuit Court should determine and specify a reasonable time within which petitioner might redeem from both liens, or be forever barred (R. 38-39).

8. The case was remanded to the Circuit Court of Oregon for the County of Klamath and hearing upon the disputed issues arising from the accounting of defendant mortgagees in possession was had. The Circuit Court held:

(a) Defendants were not entitled to interest at 10 per cent on \$65,000 paid to redeem but were entitled to interest at 6 per cent.

(b) Defendants were not entitled to credit of \$16,-500 paid on tax foreclosure sale but were entitled to \$3,152.95, the amount of the lien, together with interest thereon at 6 per cent per annum.

(c) Defendants were not entitled to credit for fees for supervision of the property.

(d) Defendants were not entitled to a credit for premiums paid on insurance policies on the Murray Building from which petitioner received no benefit.

(e) Defendants were not entitled to fees paid in attempting to get a refund of the excess paid to the Collector of Internal Revenue over the amount of the lien against the property.

(f) Defendants were not entitled to credit for accounting expenses in preparing their account in the action.

(g) Petitioner was not entitled to surcharge defendant for certain alleged mismanagement of the Murray Building.

(h) A balance was found due on the accounting of rents and profits in favor of defendants; and thereafter judgment was entered against petitioner (R. 39-40).

9. Both parties appealed said decision to the Supreme Court of the State of Oregon, which heard argument thereon on November 19, 1946, and by written opinion dated January 14, 1947, reported as *Murray v. Wiley, et al.*, 180 Or. 257, 176 P. (2d) 243, affirmed the trial court on all issues except that it directed that the decree be modified to provide that defendants have a

lien upon the mortgaged property in the amount of the ascertained balance but that the personal judgment against petitioner be eliminated. The cause was remanded to the trial court for a further accounting of the rents and profits as to the period subsequent to that covered by the previous accounting. The Circuit Court was again directed to determine upon and specify a reasonable time within which petitioner might redeem from the lien of the defendant's mortgage or be forever barred by the dismissal of his suit (R. 40-41).

10. On or about the 28th day of February, 1947, the defendants served upon petitioner an accounting of the rents and profits of the property. The first page of said accounting provided the following recapitulation (R. 42):

Statement of Account	February 28, 1947	
Redemption Certificate	\$ 65,000.00	
Interest on \$65,000 at 6% from March 23, 1936, to February 28, 1947	42,658.87	\$107,658.87
Collector of Internal Revenue, tax lien \$ 3,152.95		
Interest on \$3,152.95 at 6% from April 26, 1937, to February 28, 1947	1,862.36	5,015.31
Disbursements, March 23, 1936, to February 28, 1947	25,501.01	
Interest at 6% on monthly balances of disbursements, March 23, 1936, to February 28, 1947	8,273.31	33,774.32

Total disbursements, March 23, 1936, to February 28, 1947	\$146,448.50
Receipts, March 23, 1936, to February 28, 1947	102,589.45
Interest at 6% on monthly balances of receipts, March 23, 1936, to February 28, 1947	33,218.74
	135,808.19
Balance February 28, 1947	\$ 10,640.31

11. On February 28, 1947, petitioner paid to the Clerk of the Circuit Court of the State of Oregon for the County of Klamath the sum of \$10,640.31, and there was thereupon entered a final decree declaring that petitioner had satisfied in full all liens upon the property and was thereby entitled to have the legal title reconveyed to him. The defendants were directed to reconvey to him within 10 days or have the reconveyance occur through operation of the decree. From and after February 28, 1947, the defendants surrendered possession of the Murray Building and the rents thereafter payable to petitioner (R. 42-46).

12. Petitioner did not file income tax returns for any of the years 1937 to 1946, inclusive, prior to July 15, 1947. On that date he filed returns for the years 1937 to 1946, inclusive, in which he reported business incomes (consisting of rent from the Murray Building), deductions for taxes, repairs and depreciation, and net business incomes in the amounts shown by the following tabulation:

<u>Year</u>	<u>Rent</u>	<u>Taxes</u>	<u>And Other Repairs Expenses</u>	<u>Depreciation</u>	<u>Business Net Income</u>
1937	\$11,225.00	\$ 2,055.78	\$ 472.22	\$ 2,347.62	\$ 6,349.38
1938	9,350.00	1,835.86	222.68	2,347.62	4,943.84
1939	8,125.00	1,941.18	155.63	2,347.62	3,680.57
1940	8,771.40	1,911.03	733.88	2,347.62	3,778.87
1941	8,500.00	1,817.13	101.07	2,347.62	4,234.18
1942	8,100.00	1,808.86	1,182.04	2,347.62	2,761.48
1943	8,100.00	1,763.72	258.99	2,347.62	3,729.67
1944	9,450.00	1,944.54	165.71	2,347.62	4,992.13
1945	10,100.00	2,250.41	39.84	2,347.62	5,462.13
1946	11,109.32	2,686.23	94.62	2,347.62	5,980.85
Total	\$92,830.72	\$20,014.74	\$3,426.68	\$23,476.20	\$45,913.10

The rentals reported by petitioner in his returns for the years 1937 to 1946, inclusive, as summarized in the above tabulation, were the sums which were used in the accounting approved by the court and the deductions for taxes, repairs and other expenses claimed in such returns are the sums included in said accounting approved by the court. However, through inadvertence, only \$155.71 was deducted as repairs and other expenses in the 1944 return in lieu of \$165.71 (R. 46-47).

13. On or about March 15, 1948, petitioner filed his federal income tax return for the calendar year 1947 with the Collector of Internal Revenue, Portland, Oregon, and paid the amount of \$9.41, the tax shown to be due thereon. The reported business income thereon consisted of the rentals shown for the months of January and February, 1947, in the accounting and the rentals thereafter received by petitioner for the remainder of the year. The business deductions shown thereon con-

sisted of the repairs shown for the said months of January and February in the said accounting, the repairs and taxes thereafter paid by petitioner in the remainder of the year, depreciation of \$2,347.62, and an interest deduction in the amount of \$19,575.80, being the difference between the interest credits and debits shown in the said accounting (R. 48).

14. On May 28, 1952, the petitioner having theretofore declined to execute a further consent extending the period of assessment for the year 1943 beyond June 30, 1952, the respondent mailed to petitioner a 90-day letter proposing the assessment of a tax of \$21,454.06 for that year. The said 90-day letter showed the basis for said assessment to be on the theory that by reason of the decision of the Supreme Court of Oregon handed down on June 30, 1942, the taxpayer realized gain in that year in the amount of \$43,573.91. On September 8, 1952, petitioner paid to the Collector of Internal Revenue, Portland, Oregon, the aforesaid claimed deficiency of \$21,454.06, together with interest thereon in the amount of \$10,919.02 (R. 48-49).

15. Petitioner had no income in any of the tax years 1942 through 1945 except to the extent that income from the Murray Building or income resulting from the decrees entered in *Murray v. Wiley* litigation was realized in any of such years (R. 49).

SPECIFICATION OF ERRORS

1. The Tax Court erred in holding that petitioner realized any taxable income at any time as the result of the state court proceedings in *Murray v. Wiley*, 169 Or. 381, 127 P. (2d) 112; 169 Or. 418, 129 P. (2d) 66 (1942); 180 Or. 257, 176 P. (2d) 243 (1947).
2. In the alternative, assuming without conceding that taxable income was realized as a result of said proceedings, the Tax Court erred in holding that all such income was realized in 1947.

SUMMARY OF ARGUMENT

1. The entry of the accounting and final decree in the litigation known as *Murray v. Wiley* on February 28, 1947, did not give rise to taxable income to petitioner under the well-settled rule that cancellation or reduction of a lien against property which is not a personal obligation of its owner does not result in taxable income to him.
2. In the alternative, assuming without conceding that taxable income was realized from these court proceedings, it was not taxable to petitioner in the year 1947, except as to income for the months of January and February of that year. The net rentals for the years 1937, 1938, 1939, 1940, 1941 and 1942 were taxable to petitioner in 1942, when the claim of right thereto by the Watters Group was conclusively rejected by the Oregon Supreme Court. The net rentals for the years

1943, 1944, 1945 and 1946 were taxable to petitioner in each of those years when they were received by the Watters Group who were under a legal duty as mortgagees in possession to apply said rentals for petitioner's benefit, and to account to him therefor, pursuant to the 1942 decree of the Oregon Supreme Court.

ARGUMENT

I

The court proceedings in *Murray v. Wiley* did not give rise to taxable income to petitioner.

The accounting given by the accounting defendants to petitioner in the *Murray v. Wiley* litigation was the court-approved report of their period of custody and possession of his property. Under the decisions of the Supreme Court of Oregon the defendants were entitled to certain credits for expenditures made during their period of possession and use of petitioner's property. They were permitted to retain the rents from the property unlawfully appropriated by them to satisfy such approved expenditures and, as a net result, were not required to return such moneys to petitioner. The credits so allowed, together with interest, were sizable enough to be greater than the earnings from the property and interest thereon, and petitioner was required to pay to the defendants \$10,640.31 to recover his property free of their judicially determined liens. The most that can be said for such credits is that except for the fact that the petitioner's property produced earnings,

which petitioner never received, adequate enough to satisfy the bulk of these credits, petitioner, if he had so elected, might have had to pay more to recover full use and possession of his property. Does this fact generate taxable income?

Respondent's 90-day letter (R. 14-21) predicates his conclusions as to the manner in which said alleged income was realized as follows:

"The Bureau holds that by reason of the termination of the litigation relative to the possession and ownership of the Murray Building on February 28, 1947, you realized taxable income in the year 1947 in the amount of \$57,512.64, computed as follows:

Amount of 'redemption certificate' per accounting	\$65,000.00
Tax lien of Collector of Internal Revenue paid by defendants	3,152.95
<hr/>	
Total	\$68,152.95
<hr/>	
Less cash paid pursuant to decree of the court	10,640.31
<hr/>	
	\$57,512.64"

Respondent's position then is that taxable income was realized (a) upon the crediting to defendants of \$65,000.00 (which included amounts paid by the defendant Watters Group to defendants Wiley and D'Albini and not the amount required to redeem the property from the original mortgage foreclosure), and (b) upon the crediting to defendants of \$3,152.95 (the amount which would have been required to satisfy certain income tax liens against the property and not the

actual amount bid by defendants at the tax lien foreclosure sale).

These credits, which were held by the Tax Court to constitute income to petitioner, arose solely from the determination of the Oregon Supreme Court that the accounting defendants were entitled to such credits in the accounting for such particular items and amounts of the expenditures made by them. They are unrelated except in amount (and then not identical even in amount) to any transaction with which petitioner was directly connected.

Most important, these credits did not represent any *personal* liability of petitioner to the accounting defendants. The accounting defendants had no enforceable obligation against petitioner evidenced by note, mortgage, covenant or an agreement, either express or implied in law.

Their lien on petitioner's property was one which the Oregon Supreme Court found to be due under the peculiar circumstances established in the case. In its original decision the appellate court held that a decree should be entered providing that if the respective sums were not paid, the petitioner could be foreclosed by a sale subject to redemption as in other mortgage foreclosures. On rehearing, however, the court determined that this was not a suit by a mortgagee to foreclose a mortgage, but rather a suit by a mortgagor to redeem. After reviewing the authorities, the court held that its decree should be in the following form (169 Or. at p. 424; 129 P. (2d) at p. 69):

"This being a suit by the mortgagor to redeem, provisions concerning sale on foreclosure being for the benefit of the mortgagor and plaintiff having prayed only for relief in the nature of strict foreclosure, we are of the opinion that we are authorized to and in equity we should modify the last sentence of our former opinion. We apprehend that the plaintiff will not redeem from the purchasing defendants unless he is also able to and does redeem from the defendant attorneys, so the decree of the circuit court should determine upon and specify a reasonable time within which plaintiff may redeem from both liens or be forever barred."

On the second appeal, the Supreme Court specifically directed that no decree should be entered which was in the nature of a personal judgment against the petitioner (180 Or. at p. 274; 176 P. (2d) at p. 250):

"It appears that the trial court, perhaps by inadvertence on the part of counsel, entered a personal judgment against the plaintiff for the balance which was found in favor of defendants upon the accounting. The decree should be modified so as to provide that the defendants have a lien upon the mortgaged property in the amount of the ascertained balance but eliminating the personal judgment against plaintiff in that amount."

Incidentally, whether petitioner originally had any personal liability on the Pacific Savings and Loan Association mortgage is immaterial. This mortgage and the foreclosure thereof are of historical significance only and do not pertain to any of the legal relations, duties or liabilities between the parties involved in *Murray v. Wiley*, for as the Supreme Court of Oregon said on the second appeal (180 Or. at p. 261; 176 P. (2d) at p. 245):

"When defendants (Watters Group) redeemed the property from the sale on foreclosure under the Pacific Savings and Loan Association mortgage, the effect of that sale was completely wiped out."

Furthermore, the transfer of the Murray Building by petitioner to the Conger Corporation was not a transfer which itself gave rise to any obligation of petitioner to repay defendants any amount. The Supreme Court of Oregon reviewed the evidence on this point and commented on the fact that the conveyance was evidenced by the circulation of two checks for \$5,000, which were obviously for the purpose of making it appear that the Conger Corporation had purchased petitioner's interest in the Murray Building, although the defendants contended that the conveyance was made in payment of attorneys' fees. On this point, the court said (169 Or. at p. 388; 127 P. (2d) at p. 115):

"If the transaction was in fact a conveyance of the property in payment of the indebtedness owed, a safer and more candid procedure would have been to recite the cancellation of the plaintiff's debt as the consideration for the deed."

The defendant attorneys received promissory notes from the petitioner after the conveyance in payment of the indebtedness for attorneys' fees, which notes were still in their possession at the time of the decision of the Supreme Court (169 Or. at p. 391; 127 P. (2d) at p. 116). The Supreme Court concluded that the conveyance to the Conger Corporation was made to secure petitioner's indebtedness to the defendant attorneys, which were in the amounts of \$935 and \$750, respectively. Therefore, to the extent that any debt of the

petitioner owing to any of the defendants had to be satisfied in order to make payment of the indebtedness for which the alleged security was given, the amount of such attorneys' fees was the total amount of the indebtedness.

It is appropriate to examine the nature of the actual credits which were allowed against petitioner in *Murray v. Wiley*. On the first appeal, after finding that the Watters Group were mortgagees in possession, the court ordered the cause to be remanded for an accounting. On such accounting the defendants were to be entitled to a credit in the amount of \$63,711.60, plus interest at 6 per cent per annum from the date of payment, representing the amount paid for redemption of the property. They also were given credit for the amount which they had paid to satisfy the income tax lien, with interest at 6 per cent (169 Or. at pp. 415-416; 127 P. (2d) at p. 125). Thus the two principal credits which the Supreme Court of Oregon held the defendants entitled to in the accounting did not arise by virtue of any agreement between the parties that such moneys would be expended on petitioner's behalf. On the contrary, they represented amounts expended by the defendants in an effort to obtain good title to the property in themselves.

Petitioner cannot be considered to have received income on account of the two disbursements made by the accounting defendants, unless there had existed a personal obligation owing by him to the defendants to repay them for such disbursements made in prior years. However, as explained above, no such personal liability existed.

While the satisfaction of the lien, as found by the final accounting between the parties, may be considered as a discharge of obligations relating to petitioner's property, it is a well-settled principle that the reduction, satisfaction or cancellation of an indebtedness or obligation which is not a personal obligation of the owner of property does not result in taxable income to him. At most, it may result in some adjustment in the basis of the property.

For instance, where a property was purchased subject to a mortgage which was not assumed and the mortgage indebtedness was subsequently satisfied for less than face before maturity, the Board of Tax Appeals held that such payment did result in the liquidation of a personal debt: "By it the petitioner merely satisfied an encumbrance on property in which it had an equity and there was no release of assets 'previously offset by the obligation' of the notes or bonds evidencing the debt secured by the mortgage." *Fulton Gold Corporation*, 31 BTA 519, 521.

In *P. J. Hiatt*, 35 BTA 292, the taxpayer was the owner of lands in a reclamation district which were mortgaged in an amount in excess of their then fair market value. The reclamation district had levied an assessment against the lands which was not a personal obligation of the taxpayer. To protect its mortgage the mortgagee advanced moneys in the purchase of bonds which were applied in satisfaction of the assessment. The Board held that even though the bonds reduced the debt against the petitioner's land, no gain, profit or income could be spelled out of such a transaction.

See also: *American Seating Co.*, 14 BTA 328; *A. M. Lawrence*, 13 BTA 463; *Union Pacific Railroad Company*, 32 BTA 383, aff'd 86 F. (2d) 637; *The Ernst Kern Company*, 1 T.C. 249; *Hotel Astoria, Inc.*, 42 BTA 759; and *Terminal Investment Co.*, 2 T.C. 1004.

This principle of law was followed by the United States Court of Appeals for the Fifth Circuit in the case of *Hilpert v. Commissioner*, 151 F. (2d) 929, reversing 4 T.C. 473. In that case, as in this, the taxpayers had given a deed to one Markell which they considered to be a mortgage. Litigation was subsequently instituted in the state courts in Florida which resulted in a determination that the deed, although absolute on its face, was in fact a mortgage. The courts fixed a period within which the taxpayers would be allowed to redeem their property or else be barred from all right, title and interest therein. In summarizing the facts relating to credits similar to those here involved, the Court of Appeals stated (151 F. (2d) at p. 930):

"The court also took an accounting of the rents collected by Markell and his vendees, who were decreed to be in privity with him. After allowing Markell interest at 6 per cent on the \$65,000, and after deducting the rents collected by Markell, the court found that the amount necessary to redeem was \$54,364.67. The net rentals collected by Markell paid the interest and reduced the \$65,000, which he had paid the Hilpers, to the sum of \$54,364.67."

The *Hilpert* case involved two additional facts, neither of which is material to the point at issue in this case. The taxpayers there had reported the original conveyance of the property as a sale. This may have

conditioned the thinking of the court as to the equities of the situation, but it is obvious from the opinions of both the Tax Court and the Court of Appeals that the manner of reporting the original transaction was not determinative of the taxable effect of the conclusion of the successful litigation. The taxpayers had also made arrangements to sell the property immediately upon the completion of the litigation; funds were advanced by the purchaser to redeem the property; and the property ended up in the hands of such purchaser rather than in the hands of the taxpayers. This fact was material in the court's decision with respect to the taxable gain involved in such sale but was not pertinent to the theory of the decision which is applicable here.

In the *Hilpert* case the taxpayers received credit of \$10,635.33 of net rentals collected by the mortgagee in possession, which went to reduce the amount they were or would have been required to pay to redeem the property. The Court of Appeals nevertheless correctly held that since there was no present personal liability on the taxpayers, they had received nothing out of the transaction giving rise to taxable income other than the amount received from the purchaser.

It should be noted that in the *Hilpert* case the mortgage which the court refers to was given by the taxpayers to the mortgagee in possession, and a payment of \$65,000 had actually been made by the mortgagee in possession to the taxpayers. In the instant case, the Oregon courts found no such moneys paid by the accounting defendants to the petitioner. While the Oregon Supreme Court held that the accounting defendants were in the

position of mortgagees in possession, the original consideration to them, and then only to two of them, was solely as security for an indebtedness. In other words, the petitioner here at no time received anything of value which constituted a satisfaction of any indebtedness owing by him arising from the receipt of funds from the defendants. Petitioner contends that in this respect the instant case is even stronger on its facts than the *Hilpert* case for the application of the rule that no taxable income arises from the reduction or satisfaction of a lien against property where the owner has no personal obligation with respect thereto.

In the case at bar, the court below refused to follow the decision of the Court of Appeals for the Fifth Circuit in the *Hilpert* case, as well as the principle enunciated in its own decisions above cited. We respectfully submit that the *Hilpert* case, which has not been overruled or distinguished since its promulgation, should be followed by this court. Under the principle of that case, a decision is required here that petitioner did not realize any taxable income by reason of the *Murray v. Wiley* litigation.

II

Assuming arguendo that petitioner realized taxable income from the *Murray v. Wiley* litigation, such income in 1937-1942 was taxable to petitioner in 1942 by virtue of the decision of the Oregon Supreme Court, and the income thereafter received by the Watters Group in 1942-1947 was taxable in the respective year of actual receipt by these agents.

On June 15, 1947, petitioner filed returns for the years 1937 to 1946, inclusive, in which he reported net business rentals for those years. The rentals so reported were the sums approved by the trial court in the *Murray v. Wiley* accounting (R. 46-47).

On May 28, 1952, respondent sent to petitioner a 90-day letter proposing an assessment of a tax for the year 1943 in the sum of \$21,454.06. The basis for said assessment was that by reason of the decision of the Supreme Court of Oregon on June 30, 1942, in *Murray v. Wiley*, petitioner realized income in that year in the amount of \$43,573.91. Petitioner paid the claimed deficiency of \$21,454.06, with interest thereon in the amount of \$10,919.02 (R. 48-49).

Although petitioner has twice paid an income tax on the net rentals of the Murray Building in the years 1937, 1938, 1939, 1940, 1941 and 1942, and has once paid a tax on net receipts in the years 1943, 1944, 1945, 1946 and 1947, the Tax Court in this proceeding has held that \$57,512.64, the entire amount of net rentals, minus interest, which was realized during these years up

to February 28, 1947, was ordinary income to the petitioner in the year 1947.

The crux of Judge Arundell's opinion on this point is that petitioner had not constructively received any income until the conclusion of the accounting proceeding in February, 1947, that he was out of control of the property, and that nothing was set aside for petitioner or available to him from the rents received during the intervening years. The court concluded: "Until the accounting proceeding was actually terminated there was no definite apportionment of the income from the property between the petitioner and the mortgagees in possession, and petitioner had no right to demand payment of the rents from the property and convert them to his own use." (R. 74.)

The Tax Court fell into clear error in applying the doctrine of constructive receipt, and in failing to interpret properly the effect of the decisions of the Supreme Court of Oregon in 1942 with respect to petitioner's rights in the Murray Building.

In its first opinion the Oregon court concluded (1) the deed to the Conger Corporation was in equity a mortgage; (2) the Watters Group were not bona fide purchasers without notice; (3) on the contrary, the Watters Group were mortgagees in possession; and (4) petitioner was the beneficial owner of the property subject to the defendants' liens (R. 36-37, and 169 Or. at pp. 400, 414; 127 P. (2d) at p. 126). On the second appeal, the Oregon court explicitly rejected the defendants' contention that they had become mortgagees in

possession only by virtue of the earlier decision of the court. On this point the Oregon court wrote: "We merely declared that in the eyes of equity they had been and were mortgagees in possession." (180 Or. at p. 268; 176 P. (2d) at p. 248.)

Consequently, it is undisputed that the defendants in the *Murray v. Wiley* litigation at all times were mortgagees in possession, and as such they were under the duty to account to petitioner for the rents during the entire period of their possession, although they also were entitled to have the rentals applied to the extinguishment of their liens against the property.

At all times subsequent to September 29, 1942, when the Supreme Court of Oregon denied the petition for rehearing in *Murray v. Wiley*, petitioner was the equitable owner of the Murray Building and he was entitled to the income from said property, against which defendants were entitled to set off their judicially determined liens.

In fact, the 1942 court decisions so conclusively established petitioner's right to receive or be credited with the net rentals from the Murray Building that the Watters Group could thereafter have no valid claim of right to such receipts. The respective interests of the parties in the Murray Building were determined once and for all in 1942, and the only matters left open were the mechanics and details of an accounting.

Since defendants in the *Murray v. Wiley* litigation were under a legal duty imposed by the court to account to petitioner for the net income from the Murray

Building, it follows, as a matter of law, that the income through 1942 was taxable to petitioner in that year, and that the net receipts for the years 1943, 1944, 1945 and 1946 were correctly reported by petitioner as taxable to him in each of those years.

With respect to these receipts, the accounting defendants were in the position of agents for petitioner. The settled principle of agency law that receipt by an agent is equivalent to receipt by the principal is applicable to tax cases (2 *Mertens, Law of Federal Income Taxation*, § 10.07, p. 11, and cases therein cited); *Maryland Casualty Co. v. United States*, 52 Ct. Cl. 201, modified on other grounds, 251 U.S. 342, 40 S. Ct. 155, 64 L. Ed. 297; *Huntington National Bank v. Commissioner*, 90 F. (2d) 876 (C.A. 6); *Hines v. United States*, 90 F. (2d) 957 (C.A. 7); and *United States v. Pfister*, 205 F. (2d) 538 (C.A. 8).

This principle of law has been applied by the Board of Tax Appeals and the Tax Court in such cases as *Julia A. Strauss*, 2 BTA 599; *Appeal of L & M Holding Co.*, 3 BTA 601; *F. H. Wilson*, 12 BTA 403; *Samuel E. Diescher*, 36 BTA 732, aff'd 110 F. (2d) 90 (C.A. 3); *William R. Hopkins*, 41 BTA 1292 (acquiescence noted C. B. 1940-2, p. 4); *Clarence E. Day*, BTA Memo Docket No. 105042 (1942) (§ 42, 197 P.H. Memo B.T.A. 42-499); and *S. B. Tressler*, T. C. Memo Docket Nos. 29044 and 35129 (1953) (§ 53.111 P. H. Memo T. C. 53-353).

This principle is somewhat different from the doctrine of constructive receipt as defined and limited in the

regulations of the Treasury Department (see Regulations 111, 29.42.2-2). In 2 *Mertens, Law of Federal Income Taxation*, § 10.07, p. 12, footnote 63, it is stated:

"Payment to an agent is not a true example of constructive receipt. Agency is a general conception of the law, while 'constructive receipt' is a special conception under the law of taxation and is not necessary for an understanding of the legal results of a payment to an agent."

A factual situation very similar to that at bar was presented in *William R. Hopkins* (supra). In both the present case and the *Hopkins* case the litigation involved, first, the taxpayer's claim of right to certain property which was disputed by the other party to the litigation, and, second, an ultimate decree of an appellate court that the taxpayer was at all times the owner of the property, accompanied by a direction that the losing party in the litigation account to the successful party for the earnings of the property during the time that it was withheld from the other's possession. In the *Hopkins* case, the Board of Tax Appeals held that physical receipt of earnings from the property was not necessary where the earnings were received by the taxpayer's agent or trustee. The Board stated, in language applicable here with substitution of names, dates and description of property (41 BTA at pp. 1297-1298):

"A careful appraisal of the facts convinces us that, as the decree of the Ohio court holds, constructive possession of the stock was retained by the Griffiths as security for the petitioner's debts. The Griffiths and Guardian were thus nothing more nor less than agents of the petitioner to collect the income from the Buckeye stock, and apply it as

far as necessary to the discharge of petitioner's obligations. Receipt by agents was receipt by the petitioner, and that receipt occurred prior to 1933.

"The decree of the court in 1933 did not create income. It merely declared ownership of the Buck-eye stock in 1920 and required an accounting of the proceeds and avails of such stock. The income on the stock followed its ownership and receipt occurred in the preceding years. This is true of the cash as well as the other items comprised in the accounting. The decree did not cause conversion of assets into cash or make cash income in 1933."

It may be noted that the decision in the *Hopkins* case permitted the taxpayer to escape taxation in the years in which his agent or trustee received the earnings from the property. The petitioner here has voluntarily assumed tax liability by filing tax returns for each of the years in which the defendant mortgagees were in possession and paying the tax shown thereon to be due (R. 46-47).

In *S. B. Tressler* (supra), the Tax Court held that income from the petitioner's property, collected by a receiver in possession and applied upon the petitioner's obligations to his wife, including her attorney's fees and costs, was taxable to the petitioner, a cash basis taxpayer, in the year of its collection. The court stated: "That he had no actual control of the fund and did not receive cash in hand is of no consequence."

Thus, in the case at bar, the fact that petitioner had no actual control of the Murray Building rentals during the years 1942-1947 and that he received no cash during that period is immaterial. The determining fact is that

during that period, by virtue of the first decision of the Oregon Supreme Court, the accounting defendants had been made petitioner's agents for collection of rentals, etc., and they were obliged to apply the net income from the property for petitioner's benefit in extinguishment of their liens.

The contention was made in the court below that no benefit accrued to petitioner from the net rentals until 1947 when he redeemed the property by paying in the sum of \$10,640.31, which represented the difference between the outstanding liens against the property and the credits in petitioner's favor from nearly eleven years of operations. The claim is made that petitioner never would have received credit for any of the accumulated rental income if he had not made the crucial payment in 1947. Thus, it is argued, that such an uncertainty necessitates the accumulation of income over a long period of time until the happening of an event which removes the uncertainty forever.

The fallacy of such reasoning is that it requires looking to events taking place in subsequent years in order to determine the taxability of income actually received by the taxpayer's agent in a past year. In other words, this argument could have no validity if the balance on the 1947 accounting had been in petitioner's favor and the accounting defendants had been required to pay him a substantial amount in cash. Obviously, it makes no difference whatsoever that in order to redeem, petitioner had to pay, rather than receive, a cash balance in 1947.

A short answer to this argument is that from the time of the 1942 decisions of the Oregon Supreme Court petitioner received benefit, for the court's opinions determined that he was entitled to be credited with the net rentals from the property against the defendant's judicially determined liens. This benefit from receipts prior to the decision on the first appeal accrued in 1942, and the benefit thereafter from having the net rentals applied to the discharge of the liens accrued at the time the rentals were received by the Watters Group, who were mortgagees in possession, or agents of petitioner, as far as the collection of rentals was concerned.

In the case at bar, the 1942 appeal fixed petitioner's right to be credited with the net rentals from the property. The fact that five more years passed before the final balance of accounts was determined between the parties does not change the fact that from 1942 on petitioner was the owner of the Murray Building free of any claims of the accounting defendants, except for their judicially determined liens.

It is contrary to the orderly administration of the income tax laws for either a taxpayer to withhold income, or for the government to defer the taxation of income, merely because of some uncertainty as to time of ultimate receipt by a taxpayer of funds paid to his agent, as distinguished from a substantial contingency as to the taxpayer's right to be credited with such income (see *Harbor Plywood Corporation*, 14 T. C. 158, 161, aff'd *per curiam* 187 F. (2d) 734 (C.A. 9)).

This principle is well illustrated by the leading case of *Haberkorn v. U. S.*, 173 F. (2d) 587 (C.A. 6). There the taxpayers sued to recover back a tax which they had paid in 1942 upon a corporate bonus which had been distributed that year. Two years later it was determined that the bonus base had been miscalculated, and the previous overpayment was charged back on the company's books. The district court dismissed the case on the ground that the entire bonus had been received in the year 1942 under a claim of right and that it was taxable in its entirety in the year of its receipt. The Court of Appeals affirmed the judgment of dismissal and stated (p. 589).

"These rulings result logically from the recognized and settled principle that the Federal income tax system is based on an annual accounting, which requires the determination of income at the close of the taxable year without regard to the effect of subsequent events. *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, at page 365, 51 S. Ct. 150, at page 152, 75 L. Ed. 383, in which the Court stated —'It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.' In *Heiner v. Mellon*, 304 U. S. 271, 58 S. Ct. 926, 82 L. Ed. 1337, the Court referred to a number of its prior decisions in which the rule had been applied, and in applying it in that case restated the rule in the following language: 'The federal income tax system is based on an annual accounting. Under that law the question whether taxable profits have been made is determined annually by the result of the operations of the year.' 304 U. S. at page 275, 58 S. Ct. at page

928. It is accordingly settled in the Federal income tax field that the tax on income actually received in a given year may not be withheld because the particular transaction from which such income flowed has not been completed in that year and losses may thereafter occur in a subsequent year."

To resolve a conflict between such cases as the *Haberkorn* case and the Court of Claims case of *Lewis v. United States*, 91 F. Supp. 1017, where the facts were substantially similar, the United States Supreme Court granted a petition for a writ of certiorari in the latter case (340 U.S. 903), and reversed the Court of Claims on the ground that the taxpayer at all times had claimed the full bonus as his own and therefore was obliged to pay tax on it in the year of receipt, even though in a subsequent year he was forced to repay it (*Lewis v. U. S.*, 340 U.S. 590, 71 S. Ct. 522, 95 L. Ed. 560; rehearing den. 341 U.S. 923, 71 S. Ct. 941, 95 L. Ed. 356). The *Lewis* case was subsequently followed in *Healy v. Commissioner*, 345 U.S. 278, 73 S. Ct. 671, 97 L. Ed. 1007; rehearing den. 345 U.S. 961, 73 S. Ct. 935, 97 L. Ed. 1380.

The fact that the net rentals received by the accounting defendants were subject to be applied towards satisfaction of the liens in their favor against the property does not militate against holding that they were taxable in the year of receipt by his agents, for the " * * courts have uniformly held that income is none the less such in the year of its receipt because subject to limitations upon its use and disposal." (*Standard Slag Co. v. Commissioner*, 63 F. (2d) 820, 821 (Ct. App. D. C.),

and cases cited therein.) In the *Standard Slag Co.* case, the taxpayer was engaged in the business of buying slag, produced as a by-product by iron and steel mills, and reselling it after processing. It had a contract with a steel mill for handling that company's entire output of granulated slag. One of the contract provisions stated that any surplus remaining over and above the expense of handling slag during the summer months should not be considered as profit but would be used in research and in experimental efforts towards finding a permanent market for the material. In the year 1921 the taxpayer received a large sum over and above the expense of handling the slag, and this money was expended in the next few years in research and experimental work as stipulated by the contract. The appellate court held this amount was taxable in the year of its receipt notwithstanding it was subject to an enforceable restriction upon its use.

Under these settled legal principles, the postponement of a final accounting between the parties in *Murray v. Wiley* from 1942 until February, 1947, could not defer the annual reporting of the income from the property for tax purposes, since it was received during those years by the accounting defendants as agents for petitioner, and they were required to apply these funds towards the extinguishment of liens against petitioner's property.

Therefore, the Tax Court erred in holding that petitioner realized income in the sum of \$57,512.64 in the year 1947 by reason of the termination of the *Murray v. Wiley* litigation.

CONCLUSION

The decision of the Tax Court of the United States should be reversed, and this case should be remanded for further proceedings in accordance with the opinion of this Court.

Respectfully submitted,

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